

December 23, 1998

D.T.E. 98-78/83-A

Petition of Cambridge Electric Light Company, Commonwealth Electric Company, and Canal Electric Company for Approval of Asset Divestiture.

Petition of Eastern Edison Company and Montaup Electric Company for Approval of a Sale by Montaup of its interest in the Canal 2 generating facility to Southern New England, L.L.C.

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## I. INTRODUCTION

On July 31, 1998, Cambridge Electric Light Company ("Cambridge"), Commonwealth Electric Company ("Commonwealth"), and Canal Electric Company ("Canal") (together, the three Companies are referred to as "COM/Elec" or the "Companies;" see also n. 4 below) filed a petition with the Department of Telecommunications and Energy ("Department") for approval of the sale of substantially all of their non-nuclear generating assets to Southern Energy New England, L.L.C. ("asset divestiture"). The matter was docketed as D.T.E. 98-78. On August 7, 1998, Eastern Edison Company ("EECo") and Montaup Electric Company ("Montaup") filed a petition for approval of a sale by Montaup of its interest in the Canal 2 generating facility to Southern New England.<sup>(1)</sup> The matter was docketed as D.T.E. 98-83. Subsequently, the two proceedings were consolidated.<sup>(2)</sup>

On October 30, 1998, the Department issued an Order approving the asset divestiture by COM/Elec of its non-nuclear generation assets to Southern. Cambridge Electric Light Company/Commonwealth Electric Company/Canal Electric Company/Eastern Edison Company/Montaup Electric Company, D.T.E. 98-78/83. The Department also approved the asset divestiture by EECo and Montaup of their interest in the Canal 2 generating facility to Southern. Id.

However, the Department determined that additional information was needed with regard to a special purpose affiliate, Energy Investment Services ("EIS"), proposed by COM/Elec to hold and manage the proceeds from the sale of the Canal 1 and 2 generating facilities. Id. at 31-32. In addition, we stated that "there is not sufficient information in the record to decide how the proceeds from the sale of Canal should be allocated between Cambridge and Commonwealth" and determined that additional evidentiary hearings were needed. Id. at 23.

An additional day of evidentiary hearings was held on November 30, 1998.<sup>(3)</sup> COM/Elec presented the testimony of Russell D. Wright, chief executive officer of COM/Elec and Commonwealth Energy Systems ("COMEnergy");<sup>(4)</sup> Michael R. Kirkwood, director of supply administration, transmission services and system control for COM/Elec; Robert H. Martin, manager of regulatory accounting for COM/Elec and Commonwealth Gas Company; and James D. Rapoli, financial vice-president for COMEnergy. At the conclusion of the evidentiary hearing, COM/Elec, MIT, the Compact and the Attorney General filed briefs.<sup>(5)</sup> The evidentiary record now consists of 190 exhibits and 34 record requests.<sup>(6)</sup>

## II. ENERGY INVESTMENT SERVICES

### A. Introduction

The Companies propose to allow Cambridge and Commonwealth to retain the net proceeds from the sale of the units that each of the two companies owns independently (Exh. RHM-1, at 13). However, with regard to the proceeds from the Canal units, the Companies propose to establish a special purpose affiliate, EIS, which would hold and

manage the Canal proceeds net of the Canal-related fixed component of the transition charge and net of income taxes (Exh. RDW-1, at 10). The Companies state that the funds would be administered by EIS "with the goal of preserving principal and maximizing earnings for the benefit of retail customers" (id. at 11). EIS would credit the proceeds and any return earned on them, to the account of Commonwealth only<sup>(7)</sup> (Exh. RHM-1, at 14). These proceeds would be paid to Commonwealth as required by the transition charge calculation formula. Commonwealth would credit this fund value with any tax benefits to its transition charge account (id.). This arrangement would result in a reduction in the transition costs (id.).

The Companies explain that, for the proceeds that are not transferred to EIS, the return would be 13.29 percent, the return approved as part of the Companies' Restructuring Plan (id. at 16). However, for the proceeds that are managed by EIS, a return would be set equal to whatever return EIS is able to earn on the proceeds (id.). For illustrative purposes, in the schedules showing the calculation of the transition charge, the Companies have used a rate of return ("ROR") of seven percent, which they state is "an estimate of the future rate of EIS' investment portfolio over the amortization period" (id.).

## B. Positions of the Parties

### 1. Attorney General

In Phase 1 of this proceeding,<sup>(8)</sup> the Attorney General argued that the Companies' proposal is a violation of the Restructuring Act ("Act").<sup>(9)</sup> D.T.E. 98-78/83, at 26. The Attorney General also claimed that the seven percent ROR assumed by the Companies results in a \$70 million loss to Commonwealth ratepayers. Id. at 27. The Attorney General contended that the EIS proposal results in asymmetry for the ratepayers because they would be paying high carrying charges on items included as stranded investments, while receiving a return on the gains from the sale of the generating units of about one-half that rate. Id. at 27-28. The Attorney General recommended that the Department reject the Companies' proposal for these reasons and stated that the proceeds could be used to net out stranded costs or buy back stocks and bonds. Id. at 28.

For Phase 2 of this proceeding, the Attorney General reiterates his argument about the asymmetry of the Companies' proposal (AG Brief at 4). The Attorney General argues that the Companies have multiple uses for the proceeds, such as paying off Canal's investment in Seabrook and ongoing capital needs for Commonwealth's distribution system (id.). The Attorney General also claims that the Companies' claim of financial hardship that would result from being required to pay the ROR approved in the Restructuring Plan "can at best be described as exaggerated" (id.). The Attorney General claims that even if one were to put aside the multiple uses of the proceeds which would provide ratepayers with a reasonable return, the evidence that the Companies provided to demonstrate financial hardship is specious (id.).

## 2. Compact

In Phase 1 of this proceeding, the Compact stated that the Companies' proposal is "clearly worse from the ratepayers' perspective" than what was approved in the Restructuring Plan. D.T.E. 98-78/83, at 28. The Compact also agreed with the Attorney General that there is not a sufficient basis on the record to approve the proposed change from the Companies' Restructuring Plan. Id. The Compact found it "particularly troubling" that ratepayers will pay high carrying costs on Seabrook-related transition costs while receiving low returns on the additional proceeds from Canal. Id. The Compact contended that the Companies' proposal should be approved only if there is a compelling reason to do so, and it states that it finds no such compelling reason in the record. Id.

For Phase 2 of this proceeding, the Compact puts forth several additional arguments in opposition to the Companies' proposal. The Compact argues that since Boston Edison Company ("BECo") and Massachusetts Electric Company ("MECo") were able to provide their customers with the same ROR on their divestiture proceeds as those customers were paying for stranded assets, the Department should reject the Companies' proposal, which strays from this principle (Compact Brief at 10). Further, the Compact argues that the Companies' bankruptcy analysis presents a "worst case scenario" and that, even then, the Companies still achieve coverage ratios that are not below minimum requirements (id. at 4-5). The Compact also states that the Companies have many productive ways to use the proceeds, such as buying down Commonwealth's share of the Seabrook investment, funding ongoing transmission and distribution system capital projects, and buying down regulatory assets (id. at 5). For these reasons, the Compact argues that the Department should require the Companies to pay ratepayers the "fair" return included in the Restructuring Plan (id. at 6).

## 3. The Companies

In Phase 1 of this proceeding, the Companies asserted that the formation of EIS for managing the proceeds from Canal 1 is consistent with the Act. D.T.E. 98-78/83, at 30. The Companies stated that, in the absence of investment opportunities through Canal that would provide a ROR equivalent to the ROR in the Companies' Restructuring Plan, management of the additional proceeds by EIS will ensure that the proceeds are invested conservatively over time in order to protect the principal, while maximizing the value of the proceeds for customers and providing a consistent rate reduction over the amortization period of the Residual Value Credit ("RVC"). Id. at 29. The Companies also stated that segregation of the proceeds in EIS will provide significant tax benefits. Id. The Companies argued that if they were ordered to give the ROR set forth in the Restructuring Plan, then the magnitude of the proceeds needed to pay ratepayers could lead to the bankruptcy of the Companies. Id. The Companies also explained that returning all proceeds in the first year would result in a transition charge of -5.5 cents per kilowatthour ("KWH") in that year and a transition charge of 4.4 cents per KWH in the following year, resulting in an increase in rates by about ten cents per

KWH between the first and second year. Id. at 30. The Companies also contended that the Attorney General's proposal for the Companies to pay down Canal's unrecovered balance of about \$200 million in Seabrook is not a practicable alternative because the equity holders expect to be paid a return of, and on, their investment in Seabrook and because a market premium over book value would need to be paid to shareholders if shares of Seabrook were bought back. Id. at 30-31.

For Phase 2 of this proceeding, the Companies reiterate that providing the ROR specified in the Restructuring Plan would cause the Companies extreme financial hardship (COM/Elec Brief at 20-22). The Companies state that they performed a financial analysis that demonstrates that if the Companies are ordered to provide a ROR of 13.29 percent for the above-book proceeds of Canal, they could end up with a return on equity of 4.51 percent and a pre-tax interest coverage ratio of 1.51 (Exh. DTE/COM-4-8). The Companies argue that such a result would make it difficult for the Companies to attract capital and finance their borrowing needs in the future (id.). The Companies now state that they are amenable to the idea of investing the proceeds in "reasonable investment opportunities" such as offsetting regulatory assets and buying out above-market purchase power agreements ("PPAs") (COM/Elec Brief at 23). The Companies also state that the proceeds may be used to buy out their obligation with the Pilgrim power station in Plymouth (Tr. at 666, 678-679). The Companies also claim that allowing a lower ROR on the proceeds is analogous to the allowed return for deferrals (COM/Elec Brief at 23). The Companies state that the Department allowed the Companies a lower return (i.e., 5.99 percent) on deferrals because the Department assumed that these deferrals would be financed through short-term borrowing, rather than through the capital structure (id. at 23-24).

The Companies claim that the main reason for proposing a treatment of the proceeds that does not adhere to the Restructuring Plan is the unexpected magnitude of the proceeds received from the divestiture auction (id. at 20). The Companies state that a subsequent analysis performed by the Companies revealed that the formula used in the Restructuring Plan to compute the carrying charges associated with the return of the proceeds contained a conceptual flaw (i.e., the application of the formula could cause substantial (and unanticipated) financial harm to the Companies) (id.). The Companies state that the magnitude of the above-book proceeds for the Companies' assets was not known and thus, the effect on the carrying charges applied to the RVC was incalculable at the time the Restructuring Plan was filed or approved (id.).

The Companies contend that the Attorney General's and the Compact's arguments concerning the establishment of the EIS are without merit (id. at 25). The primary reason given by the Companies is that there is no guarantee that the sources of investment that could be bought down with the proceeds (i.e., regulatory assets, PPAs) will materialize; thus, the Companies could be put under financial stress if they are required to provide the ROR specified in the Restructuring Plan (id.). The Companies also argue that paying down the unrecovered balance of the Seabrook unit could have significant negative tax implications for the Companies (Tr. at 672-673). The

Companies also counter the Attorney General's claim that the Companies have "exaggerated" their claims of financial hardship by stating that it is unclear why the Attorney General believes that the Companies' forecasted 4.5 percent return on equity and the potential inability of the Companies to borrow because of failure to meet coverage ratios are "specious" claims of financial hardship (COM/Elec Brief at 25). Finally, the Companies argue that the Compact is incorrect in its assertion that the Companies are in the same position as New England Power ("NEP"), BECo and Montaup because the magnitude of the proceeds was much higher for the Companies than for NEP, BECo and Montaup (*id.* at 26). The Companies claim that requiring them to provide the ROR specified in the Restructuring Plan would set up an absurd penalty by potentially harming the Companies financially for their "bad luck" of having had a successful divestiture auction (*id.* at 26-27).

### C. Analysis and Findings

In February 1998, the Department approved the Companies' Restructuring Plan, which called for a ROR of 13.29 percent to be earned on transition costs and to be paid by the Companies on net gains. In the instant proceeding, the Companies claim that the fact that they received almost six times book value for their generation assets would create an unanticipated negative consequence (*i.e.*, financial instability) for the Companies if they were required to pay the 13.29 percent ROR. In addition, the Companies state that their analysis indicates that requiring the Companies to pay the ROR approved in the Restructuring Plan could put them at the brink of bankruptcy. Furthermore, the Companies also argue that additional deferrals of above-market PPA costs could exacerbate the financial difficulties for the Companies and perhaps push them into bankruptcy. The Companies note that financial instability was not anticipated as a result of the application of the RVC when it was proposed by the Companies as part of their Restructuring Plan.

There are conditions under which the Department can and should allow electric companies to depart from a previously approved restructuring plan. In fact, the Department has previously exercised its discretion to alter provisions approved as part of a restructuring plan. In Massachusetts Electric Company, D.P.U./D.T.E. 97-94, at 12 (1998), the Department approved changes to the terms of the contract termination charge that previously had been approved as part of MECo's Restructuring Plan. The Department approved the proposed modifications as consistent with the Act and with the Department's goals of "near term rate relief, rate stability and an orderly, expeditious transition to competition." *Id.* at 37. In exercising such discretion, the Department is mindful of the dictates expressed in Boston Gas Company v. Department of Public Utilities, 367 Mass. 92, 104 (1975), wherein the Supreme Judicial Court ("SJC") stated:

A party to a proceeding before a regulatory agency such as the Department has a right to expect and obtain reasoned consistency in the agency's decisions. This does not mean that every decision of the Department in a particular proceeding becomes irreversible in

the manner of judicial decisions constituting res judicata, but neither does it mean that the same issue arising as to the same party is subject to decision according to the whim or caprice of the Department every time presented.

Consistent with the Boston Gas Company decision, the Department notes that a significant or material change in circumstances may warrant a departure from a previous ruling or determination. For example, in Boston Edison Company v. Department of Public Utilities, 417 Mass. 458, 464-65 (1994), the SJC held that the Department may properly refuse to revisit decisions where the change in circumstances was anticipated. Where the change is "extraordinary," it may be appropriate for the Department to reconsider an earlier decision.<sup>(10)</sup> Boston Edison Company v. Department of Public Utilities, 419 Mass. 738, 747-748 (1995). A recent application of this principle can be found in our decision in Petition of MCI WorldCom Corporation, D.T.E. 98-85, at 13 (1998), where we determined that Bell Atlantic must implement intraLATA presubscription by April 20, 1999, rather than upon entry into the interLATA market, as previously ordered by the Department in NYNEX, D.P.U./D.T.E. 96-106 (1997). In doing so, we stated that it "would be unfair to Massachusetts consumers if the Department failed to reassess the timing question given the significant change in circumstances." Id.

In this proceeding, the Department finds that the magnitude of the proceeds that the Companies have received from the sale of the Canal facilities has created "changed circumstances" that warrant the Department using our discretion to alter the application of the RVC. The Companies' financial analysis shows that the consequences for the Companies could be serious (Exh. DTE/COM-4-8). While requiring the Companies to pay the ROR specified in the Restructuring Plan may not by itself result in bankruptcy, the Department is persuaded at this time that significant damage could be done to the financial health of the Companies. This damage could result in a degradation of the Companies' bond ratings, resulting in an increased cost of borrowing, which, in turn, would mean higher rates for ratepayers.

In Phase 2 of this proceeding, the Companies stated that all possibilities for mitigating the EIS proceeds would be explored. Specifically, the Companies have agreed to net out the regulatory assets that are approved by the Department. In addition, the Companies have agreed to pursue the buyout of above-market PPAs, including the Pilgrim contract. Once the Companies have pursued all of the investment alternatives including, but not limited to, netting out regulatory assets and buying out PPAs, the proceeds remaining to be invested in EIS are expected to be significantly lower. Therefore, the financial impact on ratepayers of allowing a lower ROR on the above-book proceeds is likely to be small.<sup>(11)</sup> Moreover, if the alternative uses for the funds do not materialize or are delayed, allowing a lower ROR would protect the Companies from serious financial harm, and consequently protect ratepayers from increased rates

due to downgraded bond ratings. In addition, the Department wants to avoid creating a perverse result whereby the better a company does in the sale of its assets, the greater its financial hardship. Therefore, the Department finds that the Companies are permitted to establish the EIS, if in the exercise of management judgment they find it warranted to do so, and further that they are not required to pay a ROR higher than what they are able to earn from EIS. However, the Department orders the Companies to net against the sale proceeds all of the regulatory assets that are approved by the Department in the Companies' upcoming reconciliation proceeding. The Department also orders the Companies to explore all other uses of the proceeds that would provide ratepayers with a ROR more in line with the ROR included in the Companies' Restructuring Plan. Finally, COM/Elec is ordered to provide the Department with two reports -- one within six months from issuance of this order, and one within one year of issuance of this order -- that update the Department as to the Companies' efforts to use the EIS proceeds through investment opportunities that would provide ratepayers with a higher return on these funds. Upon review of the annual report, the Department may revisit the issue of the ROR applied to the EIS proceeds and adjust that rate, but only on a going-forward basis, to ensure ratepayers receive the maximum return without significant adverse effect on the financial health of the Companies.

### III. ALLOCATION OF PROCEEDS BETWEEN CAMBRIDGE AND COMMONWEALTH

#### A. Introduction

Several options were explored during the Phase 1 proceeding for allocating COM/Elec's proceeds from the sale of the Canal units to Cambridge and Commonwealth.

Under the first option, all the proceeds would be allocated as approved in the Companies' Restructuring Plan -- that is, 80.06 percent would go to Commonwealth and 19.94 percent to Cambridge. This option was supported by MIT.

Under the second option, the proceeds would be allocated as proposed by the Companies -- that is, dividing the book value portion of the proceeds using a ratio of 80.06:19.94 for Commonwealth and Cambridge, respectively, and then allocating the remaining proceeds entirely to Commonwealth. This option also was supported by the Attorney General and the Compact.

Another option arose during hearings in Phase 1 (Tr. at 176-179, 456-460, 487-491). This third option first separates COM/Elec's proceeds from the sale of Canal between those received for Canal 1 and those received for Canal 2. It then allocates 25 percent of the proceeds from Canal 1 and all of the proceeds from Canal 2, using a ratio of 80.06 percent to Commonwealth and 19.94 percent to Cambridge as approved in the

Companies' Restructuring Plan. The remaining 75 percent of Canal 1 proceeds would go entirely to Commonwealth.

Under the third option discussed above, the proceeds will have to be divided between Canal 1 and 2, because Southern provided a single bid for the Canal generating units and the site. As part of the proceeding in Phase 2, various methods for dividing the proceeds between Canal 1 and 2 were discussed.<sup>(12)</sup>

Another consideration explored during the course of this proceeding was dividing the proceeds on a 88.96/11.04 percent basis, which represents the historical allocation of costs between the two companies, instead of the Companies' proposed split of 80/20 (Exh. DTE/COM-3-1). An 88.96:11.04 ratio can be used in conjunction with any of the three options described above.

## **B. Positions of the Parties**

### **1. Attorney General**

In Phase 1 of this proceeding, the Attorney General argued that the Department should approve the Companies' allocation proposal. D.T.E. 98-78/83, at 16. The Attorney General noted the historic disparity in the allocation of costs for the Canal unit and the disparity in rates between Cambridge and Commonwealth, stating that alleviating that rate disparity is one of the goals of the Act. Id.

For Phase 2 of this proceeding, the Attorney General reiterates that the Department should approve the Companies' proposal because it is "fair and reasonable" (AG Brief at 1). In support of his position, the Attorney General points to the recent Federal Energy Regulatory Commission ("FERC") order ruling that the allocation of the proceeds is not governed by the allocation of the costs (id. at 3, citing Cambridge Electric Light Company, et al., EC98-50-000 and ER98-4088-000, et al., slip opinion at 17 (Nov. 12, 1998)). The Attorney General states that a fair and reasonable allocation of the proceeds should recognize that while Cambridge has paid 20 percent of the costs of the Canal units since 1989, the percentage of costs paid by Cambridge has varied over time, and has averaged 11.04 percent (id. at 2). The Attorney General also reiterates his arguments about the alleviation of the rate disparity between Cambridge and Commonwealth being a desirable goal of the Companies' proposal (id. at 2).

### **2. Compact**

In Phase 1 of this proceeding, the Compact contended that the Companies have latitude in allocating the above-book value proceeds. D.T.E. 98-78/83, at 19. The Compact also argued that the Department was not bound by the 1991 FERC Order approving a Settlement ("FERC Settlement")<sup>(13)</sup> allocating the proceeds 80/20 percent. Id. The Compact contended that the Companies' proposal should be approved because it would result in immediate rate reductions, advance the competitive market, minimize rates in

the long run by avoiding deferrals and reduce the disparity of rates between Cambridge and Commonwealth. Id. at 21.

In Phase 2 of this proceeding, the Compact claims that the only risk Cambridge and Commonwealth bore from 1966 forward was that Canal would fail to operate properly, leaving them to share risk with Montaup, BECo, and NEP (Compact Brief at 4). The Compact observes that Cambridge has borne an average of only 2.75 percent of Canal 1's costs and 5.5 percent of Canal 2's costs (id. at 5-6). Noting FERC's recent order stating that the allocation of proceeds is not tied to the allocation of costs, the Compact maintains that the Department should defer to the Companies' proposed allocation, to the extent the Companies have discretion over allocation of the proceeds, unless the Companies' proposal violates case law or regulatory principles (id. at 7). The Compact did not comment on the method described in the Department briefing question except to state that it does not believe that option three is an appropriate approach to allocate the excess proceeds (id. at 7, n.9). Noting BECo's recent proposal to charge standard offer customers 3.8 cents per KWH in 1999, the Compact reiterates the argument that accepting the Companies' proposal (with the associated increase in standard offer generation price to 3.5 cents per KWH) will help advance the competitive market, which is a central goal of the Act (id. at 8-9).

### 3. MIT

In Phase 1 of this proceeding, MIT contended that all of the proceeds from the sale of Canal should be allocated between Commonwealth and Cambridge on an 80/20 percent basis, respectively. D.T.E. 98-78/83, at 17. MIT argued that to do otherwise would violate the Restructuring Plan. Id. MIT claimed that there is no basis for shifting costs between Cambridge and Commonwealth since they are separate legal entities. Id. In addition, the Companies' proposal would violate the Act because the Companies have failed to minimize the transition charge for Cambridge's customers. Id. MIT also argued that the Companies' proposal would be in contravention of the FERC Settlement which established the 80/20 ratio for the allocation of costs between Commonwealth and Cambridge. Id. at 18. Finally, MIT argued that the Companies' proposal is unnecessary because Commonwealth could achieve the 15 percent rate reduction without any shifting of the proceeds. Id. at 18-19.

In Phase 2 of this proceeding, MIT contends that any deviation from the approved allocation in the Restructuring Plan, is unsupported by purported changed circumstances and would be arbitrary and capricious (MIT Brief at 1-2). In support, MIT points to Boston Gas Company v. Department of Public Utilities, 367 Mass. 92, 104, where the SJC states that ratepayers have a right to expect "reasoned consistency" in agency decisions (MIT Brief at 4).

MIT claims that the "historical" 88.96/11.04 percent split would divorce reward from risk (id. at 2). MIT argues that ownership shares at the time of sale represent the risk of loss and that this risk was divided 80/20 between Commonwealth and Cambridge,

respectively (id.). According to MIT, "Cambridge ratepayers bore 20 percent of the real, going-forward risk, not some other percentage" (MIT Brief at 6). MIT maintains that any effort to "divide" the Canal unit, in order to assign proceeds, must fail for the following reasons: (a) the capacity method ignores important operational differences between the units; and (b) basing the split on Montaup's receipt of \$75 million for 50 percent of Canal 2 ignores the fact that Montaup had no operating control or land development rights for the unit (id. at 2-3).

Finally, MIT argues that Cambridge and Commonwealth customers were at risk for the stranded costs for the Companies' entire share of the Canal units, including 75 percent of the output that was sold to BECo, NEP, and Montaup under PPAs, because the entire book value of Canal 1 was to be subtracted from the gross proceeds from the sale of the Canal units (Exh. DTE/COM-4-1 (MIT)). In support, MIT points to a new paragraph 1.1.3(c)(vi) that was inserted in the Formula for Calculating Transition Charges as part of the Companies' compliance filing in DTE-97-111 (Tr. at 591-593). MIT argues that if the bid for Canal 1 was below the book value of the unit, the ratepayers of Cambridge and Commonwealth would have had to pay the difference between the book value and the bid price for the entire Canal 1 unit (Exh. DTE/COM-4-1 (MIT)). Thus, according to MIT, the ratepayers of Cambridge and Commonwealth were at risk for the entire Canal 1 unit and not just 25 percent of it.

#### 4. The Companies

In Phase 1 of this proceeding, the Companies contended that their proposal varied from the Restructuring Plan because of "changed circumstances," namely, receiving almost six times book value for their units and increased deferrals from above-market PPAs. D.T.E. 98-78/83, at 21. The Companies stated that the proposed allocation would produce more equitable rate reductions for all Cambridge and Commonwealth customers and would enable Commonwealth as well as Cambridge to achieve the 15 percent rate reduction required by the Act. Id. The Companies also argued that the FERC Settlement is not binding in this case because the FERC Settlement was not based on a cost-causation analysis. Id. at 22. Finally, the Companies stated that if something approximating its proposed allocation is not allowed, they may be unable to meet the 15 percent rate reduction and would withdraw the offer to increase the standard offer generation price from 2.8 cents per KWH to 3.5 cents per KWH. Id. at 23.

In Phase 2 of this proceeding, the Companies claim that their proposal provides immediate rate reductions, promotes competition, avoids large deferrals, enables Commonwealth to meet annual rate caps, maintains rate equity, and reduces the rate disparity between Cambridge and Commonwealth (COM/Elec Brief at 8). The Companies maintain that even with their proposed allocation, the transition charge will decline by a larger percentage for Cambridge than for Commonwealth (id. at 9, n.11). The Companies reiterate the claim that if something approximating their proposal is not adopted, they would not raise the standard offer generation price, as proposed (id. at 9).

The Companies also reiterate their claim that their proposal is consistent with and furthers the goals of the Act (id. at 10). The Companies contend that their retail customers have never been at risk for the above-book proceeds of Canal's generating assets and that Canal would have refused offers to buy Canal for less than book value (id. at 11, 18). The Companies argue that because Canal sold electricity to Cambridge and Commonwealth under federally regulated rates, the retail customers have no right to the above-book proceeds (id. at 11). In addition, the Companies argue that because Canal is a wholesale generation company exempt from most regulation under the Act, it has substantial flexibility in how to allocate the above-book proceeds (id.). The Companies claim that FERC held that their allocation proposal is consistent with FERC precedent (id. at 12-13). Regarding MIT's argument that an 80/20 allocation best matches risks and rewards, the Companies claim that Cambridge customers' risk, if any, was never more than five percent of the costs of Canal 1 and ten percent of the costs of Canal 2 (COM/Elec Brief at 16).

The Companies base their arguments for and against the various allocation proposals, in part, on their ability to meet the 15 percent rate reduction (Exh. DTE/COM-4-1). The Companies argue that option two would allow them to provide equitable rate reductions for both Cambridge and Commonwealth ratepayers, while still allowing them to meet the 15 percent rate cut (id.). The Companies argue that option one would exacerbate rate disparities between Cambridge and Commonwealth ratepayers while inhibiting the development of competition in the Commonwealth service territory (id.). The Companies' position is somewhat ambiguous with regard to option three; they state only that it would produce results not as advantageous as option two, nor as disadvantageous as option one (id.). The Companies argue that if option three is used to allocate the proceeds, then Canal 1 should be valued at the difference between the Canal station purchase price and twice Montaup's purchase price for Canal 2, because it is based on an arms-length transaction representing market value (Exh. DTE/COM-4-2).

### C. Analysis and Findings

#### 1. Introduction

The Companies have proposed to divide the above-book proceeds from the sale of the Canal units between Cambridge and Commonwealth ratepayers in a manner that is different from that approved in the Restructuring Plan. MIT claims that the Department may not approve a deviation from the Restructuring Plan approved in D.P.U./D.T.E. 97-111 because to do so would violate the doctrine of "reasoned consistency" in agency decisions. Boston Gas Company v. Department of Public Utilities, 367 Mass. 92, 104. As will be discussed in detail below, we disagree with MIT's contention, and we adopt a new allocation formula for the above-book proceeds. However, the new allocation formula is not the one proposed by the Companies, and we are changing it for reasons other than those cited by the Companies. The allocation formula approved in this Order is consistent with our long-standing principle of having reward follow risk. Commonwealth Electric Company, D.P.U. 88-135/151, at 90-94 (1989). Moreover, the method we approve today

is consistent with the goals of the Act, in that it alleviates rate disparity and minimizes transition costs, as well as with FERC precedent. Cambridge Electric Light Company, et al., EC98-50-000 and ER98-4088-000, et al., slip opinion at 17 (Nov. 12, 1998)).

## 2. Department Authority to Change the Allocation Formula

The first question concerns our authority to approve an allocation formula that is different from the approved allocation formula in the Companies' Restructuring Plan. As we discussed above with regard to EIS, the Department, in fact, has altered previously approved provisions of a restructuring plan or amended directives from an earlier Department order. See Massachusetts Electric Company, D.P.U./D.T.E. 97-94, at 12, (approving changes to terms of contract termination charge previously approved as part of MECo's Restructuring Plan); see also Petition of MCI WorldCom Corporation, D.T.E. 98-85, at 13. The Companies argue that the Department may consider changes to the Restructuring Plan and point to changed circumstances as support for their proposal. See Boston Edison Company v. Department of Public Utilities, 417 Mass. 458, 464-65. While the Department may not have revisited the allocation issue without the Companies' prompting, once the issue was raised, the Department had an obligation to investigate the Companies' proposal thoroughly. In Boston Edison Company, 419 Mass. 738, 747-748, the SJC directed the Department to reopen the record to take evidence from BECo concerning whether there had been an extraordinary change in circumstances warranting an exception from our regulations. The SJC stated that "the public interest would not be served by enforcement of a costly long-term contract if the [Department] has available to it information, which, if accurate, may result in unnecessary costs . . . ." Id. The obvious inference is that the mere existence of changed circumstances is not sufficient in and of itself, but that the agency is expected to respond rationally to the changed circumstances if warranted.

In this case, we find that the public interest is best served by acting on the additional information that we have gathered in the course of our current investigation. Information has come to light in this investigation indicating that the previously-approved allocation formula unfairly distributes a portion of the proceeds from the sale of the assets to Cambridge ratepayers at the expense of Commonwealth ratepayers. Here, we do determine that an allocation method other than that proposed by the Companies or that approved by the Department as part of the Restructuring Plan is indeed the most appropriate method of allocation because it more accurately distributes rewards in proportion to the risk borne by ratepayers.

## 3. The Companies' Proposal

The Companies have proposed a change to the allocation formula primarily because the magnitude of the proceeds presents an opportunity for the Companies to provide more "equitable" rate reductions between Commonwealth and Cambridge ratepayers and to help Commonwealth to meet the statutorily-prescribed 15 percent rate reduction for standard offer service. While we agree that ratepayer parity (G.L. c. 10, § 62) and rate reductions for standard offer service (G.L. c. 164, § 1B(b)) as outlined in the Act are

important policy goals, we do not agree that it is appropriate to take advantage of the fact that distribution companies are affiliated under one holding company to promote these goals by shifting the rewards due to one utility's ratepayers to another simply because they are affiliated companies.

With regard to gains achieved by utilities from the sale of assets, Department precedent is to adhere to the principle that reward ought to follow risk. Commonwealth Electric Company, D.P.U. 88-135/151, at 90-94 (1989). In Boston Gas Company, D.P.U. 1100, at 62-65 (1982), ruling in kindred circumstances, the Department stated the rationale for the ratemaking treatment of gains from the sale of utility property as follows:

The Company and its shareholders have received a return on the use of these parcels while they have been included in rate base, and are not entitled to any additional return as a result of their sale. To hold otherwise would be to find that a regulated utility company may speculate in . . . utility property and, despite earning a reasonable rate of return from its customers on that property, may also accumulate a windfall through its sale. We find this to be an uncharacteristic risk/reward situation for a regulated utility to be in with respect to the plant in service.

Department precedent also states that such ratemaking treatment for gains from the sale of utility property would be supported by the principle that the right to capital gains on utility assets is tied to the risk of capital losses. D.P.U. 88-135/151, at 91 (1989) citing Democratic Central Committee v. Washington Metropolitan Area Transit Commission, 485 F. 2d 786 (D.C. Circuit 1973). Finally, Department precedent states that because the risk of loss falls on customers, the benefits associated with the gains from the sale of property that has been included in a company's Electric Plant in Service or Construction Work in Progress accounts should inure to ratepayers. Commonwealth Electric Company, D.P.U. 88-135/151, at 91. Guided by these precedents, the Department finds that the reward for ratepayers in the form of above-book proceeds from the sale of generating assets should be consistent with the risk they undertook regarding the asset. In this case, the risk is best represented by the costs paid by ratepayers for the generating asset over its life. Adopting the Companies' proposed allocation formula would clearly be an improvement over option one, the 80.06/19.94 allocation proposed in the Restructuring Plan and approved in D.P.U./D.T.E. 97-111, but even that would not put the allocation on the soundest and fairest footing. Adopting the Companies' formula would deprive Cambridge's ratepayers of at least some of the rewards to which they are entitled, given the historic proportion of risk that they undertook in paying the costs associated with the Canal units. Therefore, we decline to adopt the Companies' proposed allocation formula for the above-book proceeds.

#### 4. The Appropriate Allocation Formula

Although it moves in the right direction, the Companies' proposed allocation formula does not distribute the rewards of the asset divestiture in the same proportion as the historic distribution of the risk between ratepayers of the two utilities. However, we discovered in the course of investigating the Companies' proposal that the allocation formula approved in the Restructuring Plan also does not accurately distribute the rewards in proportion to the distribution of risk.

From the time of the FERC Settlement, the costs of the Canal units have been split between Cambridge and Commonwealth in the ratio of 80.06 percent to Commonwealth and 19.94 percent to Cambridge, and that FERC Settlement ratio was used as the basis for the distribution of both the book and above-book proceeds in the Restructuring Plan. However, it was disclosed in this proceeding that the actual, measurable share of the costs for the Canal units paid by Cambridge has varied over time and has averaged 11.04 percent since the units came on-line.

In terms of the proceeds up to book value, the Department is limited by FERC requirements. The Department finds that it was correct for the Companies to allocate 19.94 percent of the Canal costs to Cambridge in the calculation of the transition charge from March 1, 1998, because the FERC decision required that the 80/20 ratio be used for that purpose. Consequently, the proceeds of the sale up to book value should also be allocated using the 80.06:19.94 ratio, so that the unrecovered book costs are properly netted out consistent with FERC requirements.

However, the Department has the discretion to determine the appropriate allocation of above-book proceeds, and we find that matching the allocation of the above-book proceeds to the historic distribution of costs is the appropriate way to ensure that reward or loss follows risk. The record indicates that a ratio of 88.96:11.04 represents the historical allocation of costs (Exh. DTE/COM-3-1). Therefore, the above-book proceeds of the sale shall be distributed between Commonwealth and Cambridge using a ratio of 88.96:11.04, respectively.

MIT contends that the risk actually is represented by the 80/20 ratio because that was the ownership share at the time of the sale and because Cambridge ratepayers were responsible for that portion of stranded costs. We disagree with MIT's conclusions. The appropriate measure of risk borne by ratepayers is the costs that actually were paid by customers over time. Commonwealth Electric Company, D.P.U. 88-135/151, at 90-94. The going-forward responsibility to pay for stranded costs is not a risk in and of itself; instead, it is the consequence of previous risks that were borne by ratepayers. In addition, the 80/20 allocation of the costs was the result of the FERC Settlement and did not represent "ownership" ratios at the time of the sale. Also, the effect of the 80/20 allocation on ratepayers is included in the measurement of the historic cost allocation as approximately seven years' worth of data.

Another important fact about the historic allocation of the costs of the Canal units was highlighted in the course of this proceeding; ratepayers of Cambridge and Commonwealth together have paid for only 25 percent of Canal 1 through retail rates

before retail access and through the transition charge after the implementation of retail access. In other words, ratepayers have borne the risk for only 25 percent of Canal 1 and shareholders have borne the risk for the remaining 75 percent. This information causes us to add an additional modification to the allocation formula for the sale proceeds. The Companies should be allowed discretion over how they allocate, between Cambridge and Commonwealth, proceeds from the remaining 75 percent of Canal 1. Consistent with the Department's determination of the appropriate allocation ratio, the Department finds that it is necessary to allocate all of the above-book proceeds from Canal 2 and 25 percent of the above-book proceeds from Canal 1 to Cambridge and Commonwealth in the ratio based on their historical cost allocation, i.e., 88.96:11.04. However, the Companies can transfer the above-book proceeds from 75 percent of Canal 1 entirely to Commonwealth, if they so choose.

MIT has argued that Cambridge and Commonwealth customers were at risk for the stranded costs for the entire share of Canal Electric in the Canal units, including the 75 percent of output sold to BECo, NEP, and Montaup under PPAs, because the entire book value of Canal 1 was to be subtracted from the gross proceeds from the sale of the Canal units (Exh. DTE/COM-4-1 (MIT)). MIT argues that if the bid for Canal 1 was below the book value of the unit, the ratepayers of Cambridge and Commonwealth would have had to pay the difference between the book value and the bid price for the entire Canal 1 unit. Thus, according to MIT, the ratepayers of Cambridge and Commonwealth were at risk for the entire Canal 1 unit and not just 25 percent of it. The Department is persuaded by the Companies' explanation that the clause concerning the subtraction of book value from the gross proceeds in the transition charge method was included for clarification only (Tr. at 591-593), and that the Companies had no intention of putting customers of Cambridge and Commonwealth at risk for the book value of Canal 1. There would have been no reason for the Companies to sell Canal 1 at below book value and try to recover the losses from the ratepayers of Cambridge and Canal instead, because the Companies could always recover the book value of 75 percent of Canal 1 from BECo, NEP, and Montaup.

Allocating the above-book proceeds differently for Canal 1 and Canal 2 requires the separation of the single bid by Southern for the Canal units into portions that can be ascribed to Canal 1 and 2. The Department notes that the matching of rewards or losses with risk should form the basis for the method used to separate the bid for Canal, and the Department finds that the method preferred by the Companies (Exh. DTE/COM-4-2) has advantages over the other methods discussed in this proceeding. Using the Companies' method, the market value of Canal Electric's share of Canal 2 is imputed to be approximately \$75 million, based on the value received by Montaup for its 50 percent share of Canal 2. The \$75 million for Canal Electric's share of Canal 2 is subtracted from the \$401 million gross proceeds received by the Companies for the Canal units, to arrive at a value of approximately \$326 million for Canal 1.

The Companies' preferred method differs from the briefing question method in that it assigns all the value of the land and other attributes of the site to Canal 1 instead of dividing them equally between Canal 1 and 2. This method is appropriate because, as the Companies state, the land at the Canal site is on the books of Canal 1 and "the ownership

of the land and the developmental rights to the site are held 100 percent within Canal Unit 1" (COM/Elec Brief at 27). Given that ratepayers of Cambridge and Commonwealth did not pay any of the costs of the land in their payments for power from Canal 2, they did not bear any of the risk associated with the Canal site. Therefore, based on the principle of matching rewards or losses with risk, the proceeds for the value of the Canal site should not be associated with Canal 2, but instead should be assigned entirely to Canal 1. As the Companies point out, other than the allocation of the value of the land, the Companies' preferred method and the briefing question method would be essentially the same (id. at 28, n. 32).

The Companies' preferred method for dividing the proceeds between Canal 1 and 2, i.e., assigning all the value of the land and other attributes of the site to Canal 1, is superior to other methods discussed during the course of the proceeding. For example, dividing the proceeds equally between Canal 1 and 2 would ignore the differences between the two units. Using the book values to divide the proceeds incorrectly assumes that the market value of the land and other attributes of the site also are proportional to the book value of the unit.

Based on the foregoing analysis, the Department directs the Companies to separate the single bid for the two Canal units into amounts for each unit in the following manner. First, they must impute a market value for Canal Electric's share of Canal 2 based on the value received by Montaup for its 50 percent share of Canal 2. Then, they are to subtract the market value for 50 percent of Canal 2 from the total proceeds received by them for the two units. The result will be the Companies' share for Canal 1. The Companies are directed to then allocate the above-book proceeds for 25 percent of Canal 1 and their 50 percent share of Canal 2 in the ratio of 88.96 percent to Commonwealth and 11.04 percent to Cambridge. The remaining 75 percent of the above-book proceeds from Canal 1 is to be allocated between the ratepayers of the two utilities at COM/Elec's discretion. Finally, the record indicates that the Companies should be able to achieve the 15 percent rate reduction under the allocation method established in this Order by the Department (Exh. DTE/COM-4-7). Consequently, the Department expects the Companies to be able to include in their compliance filing an increase in the standard offer generation price to 3.5 cents per KWH for 1999.

#### IV. ORDER

Accordingly, after due notice, hearing and consideration, it is hereby

ORDERED: That Cambridge Electric Light Company and Commonwealth Electric Company shall allocate the proceeds from the sale of the Canal 1 and 2 generating facilities as directed in Section III.C.4 of this Order; and it is

FURTHER ORDERED: That Cambridge Electric Light Company and Commonwealth Electric Company are authorized to create the Energy Investment Services as proposed, subject to the conditions described herein, including the reporting requirements; and it is

FURTHER ORDERED: That Cambridge Electric Light Company and Commonwealth Electric Company are directed to file a compliance filing within seven days of issuance of this Order; and it is

FURTHER ORDERED: That Cambridge Electric Light Company and Commonwealth Electric Company comply with all orders and directives contained herein.

By Order of the Department,

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Janet Gail Besser, Chair

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James Connelly, Commissioner

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W. Robert Keating, Commissioner

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Paul B. Vasington, Commissioner

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Eugene J. Sullivan, Jr., Commissioner

Appeal as to matters of law from any final decision, order or ruling of the Commission may be taken to the Supreme Judicial Court by an aggrieved party in interest by the filing of a written petition praying that the Order of the Commission be modified or set aside in whole or in part.

Such petition for appeal shall be filed with the Secretary of the Commission within twenty days after the date of service of the decision, order or ruling of the Commission, or within such further time as the Commission may allow upon request filed prior to the expiration of twenty days after the date of service of said decision, order or ruling. Within ten days after such petition has been filed, the appealing party shall enter the appeal in the Supreme Judicial Court sitting in Suffolk County by filing a copy thereof with the Clerk of said Court. (Sec. 5, Chapter 25, G.L. Ter. Ed., as most recently amended by Chapter 485 of the Acts of 1971).

1. Canal and Montaup are both 50 percent owners in the Canal 2 generating facility.

2. The following entities sought and received intervenor status: the Division of Energy Resources ("DOER"); Southern Energy New England, Southern Energy Canal and Southern Energy Kendall, L.L.C. ("Southern"); Cape Light Compact and Constituent Municipalities ("Compact"); and the Massachusetts Institute of Technology ("MIT"). The Attorney General of the Commonwealth ("Attorney General") filed a notice of intervention as of right, pursuant to G.L. c. 12, § 11E. Boston Edison Company ("BEC") and Western Massachusetts Company ("WMEC") were granted limited participant status.

3. COM/Elec, MIT, the Attorney General, and the Compact participated in the hearing.

4. COMEnergy is the holding company for COM/Elec.

5. The Department issued one briefing question, discussed below in Section III. A.

6. In addition, in the first phase of this proceeding, the Department incorporated by reference COM/Elec's Restructuring Plan approved in Cambridge Electric Light Company/Commonwealth Electric Company/Canal Electric Company, D.P.U./D.T.E. 97-111 (1998) (Exh. CEC-1).

7. Only the above-book value proceeds from the Canal units will be transferred to EIS. The Companies are proposing to allocate the entire above-book value portion of the proceeds to Commonwealth.

8. Phase 1 refers to the portion of this proceeding that resulted in the Order issued on October 30, 1998, D.T.E. 98-78/83. Phase 2 refers to the record developed subsequently.

9. An Act Relative to Restructuring the Electric Utility Industry in the Commonwealth, Regulating the Provisions of Electricity and Other Services, and Promoting Enhanced Consumer Protections Therein, signed by the Governor on November 25, 1997. St. 1997, c. 164.

10. We further note that in Boston Gas Company, the SJC suggests that the principle of res judicata need not be strictly applied to agency decisions. 367 Mass. 92, 104; see also Stowe v. Bologna, 32 Mass. App. Ct. 612, 616 (1992), citing Ramponi v. Board of Selectmen of Weymouth, 26 Mass. App. Ct. 826, 829-830 (1989). In Stowe, the court stated that " administrative decisions, even if adjudicatory in the sense that they determine rights and duties of specifically named persons, frequently have a regulatory component that may warrant reexamination in the light of changes in regulation, purpose, later decisional law, or applicable on-the-ground facts." 32 Mass. App. Ct. 612, 616.

11. Likewise, the impact on the Companies of requiring a higher ROR would be significantly reduced. However, if alternative uses of funds do not materialize or are delayed, requiring a higher ROR would have the deleterious financial consequences already discussed.

12. In a briefing question, the Department also asked the parties to comment on the following method for dividing the proceeds from the Canal units between Canal 1 and 2. The method consists of the following steps: (1) use the market value for Canal 2 received by Montaup (approximately \$75 million) to arrive at a market value for Canal Electric's share of the Canal 2 generating unit to be \$75 million; (2) divide the market value of the Canal 2 generating unit by its book value to arrive at a ratio of market value to book value; (3) apply Canal 2's market value to book value ratio to the book value of the Canal 1 generating unit, excluding the book value of the land, to arrive at a market value for the Canal 1 generating unit; (4) subtract the market value of Canal 1 and Canal Electric's share of Canal 2 from Canal Electric's share of the proceeds from the sale of the Canal units to arrive at the market value of the land, development rights, and other attributes of the Canal site; (5) divide the market value of the land, development rights, and other attributes of the Canal site equally between Canal 1 and 2; and (6) add the market values of the plant and the land, development rights, and other attributes of the Canal site to arrive at a total market value for each of Canal 1 and 2. This total market value for each unit would then be divided according to option three.

13. FERC Docket No. ER90-73-000 et al.(1991)